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# Understanding the Role and Requirements of Collateral in Loss-Sensitive Insurance Programs

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# *Understanding the Role and Requirements of* **Collateral in Loss-Sensitive Insurance Programs**

**Joseph L. Garzone**

Assistant Vice President, PMA Companies, Finance

Choosing loss-sensitive insurance programs is an attractive option for many organizations with predictable loss patterns, especially workers' compensation, commercial auto, or general liability. Rather than paying large premiums and transferring all the risk to their insurance company, organizations retain a portion of their risk and, in return, can lower their premiums, increase cash flow, and gain greater control over claims outcomes.

Premium savings often take center stage when insurance agents, brokers, and carriers discuss these programs with CFOs, risk managers, and other buyers of insurance. What's not always discussed and understood when considering these programs, however, is the long-term impact of the collateral required to secure the credit risk undertaken by the insurer.

Collateral is an integral part of any loss-sensitive insurance program and has a significant impact on the total cost of insurance. It's important for buyers to understand collateral requirements thoroughly, particularly its continuing financial impact beyond the first policy year.

This Executive Brief is a follow-up to PMA's white paper, *"Maximizing the Value from Loss-Sensitive Workers' Compensation Programs,"* released in 2012 and posted on our website, [www.pmacompanies.com](http://www.pmacompanies.com). This follow-up focuses on the role of collateral, how it is calculated and "stacks" over multiple years, and the pros and cons of different collateral instruments.

## **The Role of Collateral**

To better understand the impact of collateral on overall insurance costs, it's helpful to compare a loss-sensitive program like a large deductible product to a standard, guaranteed-cost insurance program. Under a standard policy, the premium dollars are used to cover the insurance carrier's operating expense and profit, with the remainder designated to pay estimated future claims.

With a large deductible, on the other hand, the premium is paid only for the operating expense/profit component, typically lowering the premium substantially. In exchange for these savings, the insurance buyer is responsible for paying losses within

the deductible layer. Yet it's important to remember that for policies such as workers' compensation, the insurance carrier is required by statute to make the payments to claimants for the insured. Insurance carriers are then reimbursed by the insured.

To secure these reimbursement obligations, insurance carriers require collateral. In these situations, collateral serves as protection against those who either cannot or will not reimburse claims they have contractually agreed to assume. It ensures the insurance company only takes underwriting risk, not financial risk.

Collateral serves two other purposes for insurance carriers. First, it enables them to maintain a certain level of statutory surplus, which is important because some receivables are not considered legitimate assets unless they are supported by collateral. Second, rating agencies like A.M. Best Company, S&P, Moody's, and Fitch take collateral into consideration when determining a carrier's solvency and its ability to satisfy anticipated liabilities.

## **Calculating Collateral Requirements**

Since claims experience is the foundation of collateral requirements, insurance carriers begin by estimating the amount of claims that organizations can expect to pay during the term of the policy. They do this by using data from prior policy years to form a "financial exposure analysis."

This analysis depends on several factors, beginning with the potential for loss. For example, in a workers' compensation program, payroll reveals the total number of employees at risk for injury. This number is correlated with claims activity. Also, since claims costs increase over time due to rising medical costs and other factors, the impact of inflation is considered, both when analyzing previous loss history and in anticipating future losses.

The financial exposure analysis also considers:

- **The “tail” on claims.** In other words, some claims, such as workers' compensation claims, may be paid for many years to come. As will be discussed below, this “tail” can have a significant impact on collateral requirements.
- **Unreported claims and potential adverse claim development.** Insurers estimate the time frame to close all claims and the final cash outlay, using loss development factors to predict the ultimate claims expense.
- **Whether a company's loss rate has been flat, rising, or falling over time.** This is a good measure of predictability, showing the variability inherent in loss rate history. It is determined by measuring trended payroll and ultimate losses. The lower the loss rate, the better.

Using a variety of averages that are weighted by the current year's payroll amount, the insurer then arrives at multiple loss estimates, ultimately choosing one as representative of the upcoming policy year exposure.

## Estimated Payout Pattern

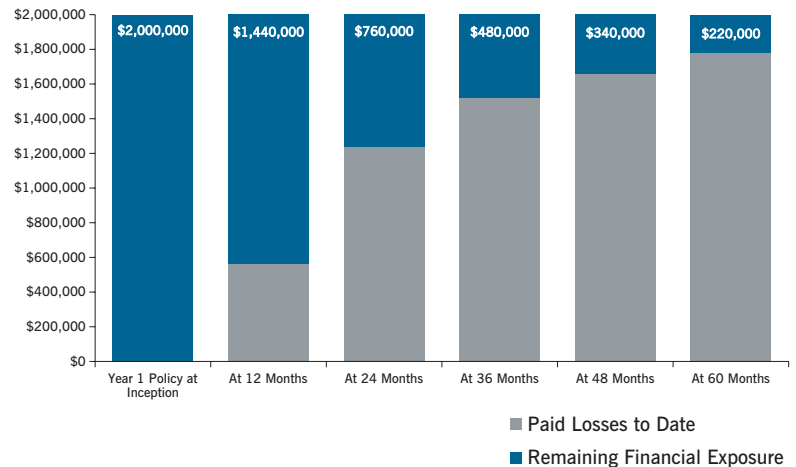
With this information, the insurer can establish an estimated payout pattern for future policy years. **Figure 1** illustrates a five-year payout pattern based upon a \$2 million estimate of policy year losses. In this example, \$2 million in collateral is required at the policy's inception to secure a \$2 million loss estimate. Assuming the estimate is correct, and 28% of these claims are paid and reimbursed in the first 12 months, \$1,440,000 in financial exposure would remain. A collateral requirement of \$1,440,000 would be necessary, even though the associated policy had expired.

In addition, because losses pay out gradually over time, a decreasing collateral amount would continue to be required until this policy year's claims were closed, perhaps seven to ten years from policy inception. This leads us to the next point, and one that is not always understood – continuing collateral requirements.

### Collateral Stacking

Collateral requirements will continue many years after policy expiration. The reason for this is simple: exposures carry over

**Figure 1: One Policy Year's Collateral Requirement**



into the next year and beyond, as seen in **Figure 1**. Collateral requirements for the policy can decrease from year to year as claims are paid, until all claims from the policy in question have been closed.

**Figure 2** (page 4) demonstrates the concept of collateral stacking, which exists because collateral is required for each policy year. Stacking results in an increasing aggregate security requirement and, therefore, is critical for the buyer contemplating a large deductible or other loss-sensitive program to understand. Assuming the estimated exposure for each policy year is \$2 million, \$1,440,000 in exposure remains after year one, because only 28% of this policy year's exposure was paid in the first 12 months.

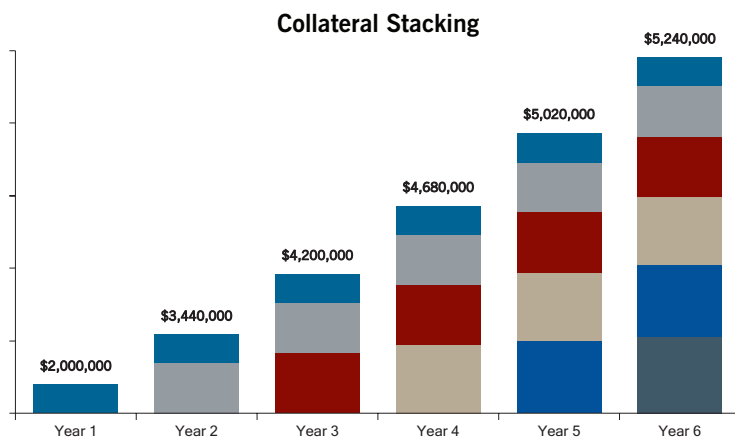
However, at the start of the second policy year, another \$2 million in exposure was added, increasing the total of the two policy years to \$3,440,000. The collateral requirement changes in kind. Moreover, as additional policy years are added, the security requirement continues to grow at a decreasing rate, until finally leveling off seven to ten years into the relationship.

It's important to note that **Figure 2** assumes the company experiences no payroll growth. If payroll does increase, so does the potential for an increase in losses. Thus, collateral must also be adjusted. **Figure 3** (page 4) illustrates this principle, assuming a 10% annual growth in payroll exposure. That increase means \$2.2 million will be added to the year two collateral requirement, as opposed to the \$2 million increase illustrated in the “no growth” example. When added to the \$1,440,000 carried over from year one, the two-year requirement in a 10% growth scenario is \$3,640,000, rather than \$3,440,000.

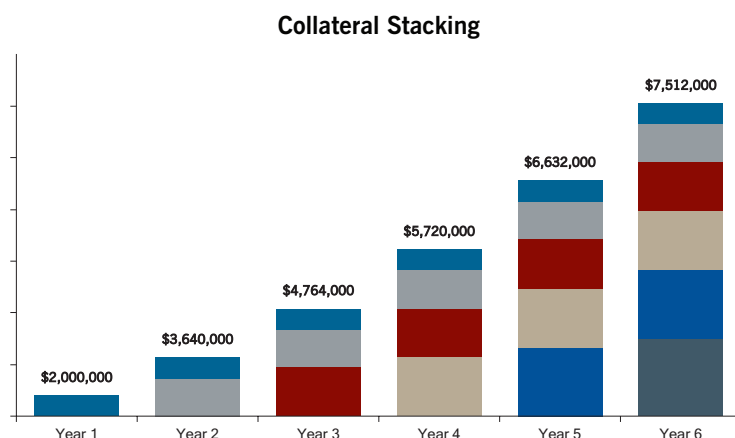


The collateral amounts are calculated with several key considerations in mind; however, while there are specific formulas for calculating these numbers, they still represent estimates of future claims payments. For that reason, collateral amounts are not determined based solely on financial exposures within an insured's deductible layer. A company's financial strength also is considered.

**Figure 2: Cumulative Collateral Requirement – No Growth**



**Figure 3: Cumulative Collateral Requirement – 10% Growth**



## Financial Strength

Analyzing financial statements can help an insurer determine whether the client is financially viable, will be able to reimburse claims, or might default on payments. Insurers prefer audited statements because they are independently verified and adhere to Generally Accepted Accounting Principles (GAAP).

The financial statement analysis involves a review of different areas of the company: balance sheet, income statement, and cash flow statement. This financial information, along with audited statement footnotes, helps the insurer form an

opinion about the company. Banking relationships are also of particular importance, since they demonstrate a credit record, including aspects such as interest rate, payback period, and credit line terms.

Typically, the final collateral requirement is equal to the estimated loss exposure. For a financially strong candidate, however, collateral may be adjusted to provide a discount. On the other hand, if a default risk is perceived, collateral will be adjusted to include a surcharge.

## Types of Collateral

Once the amount of collateral is determined, it's time to choose one of several collateral instruments to meet this obligation, all supported by a comprehensive security agreement. These instruments include letters of credit, cash held by the insurer, trust funds, and custodial accounts. The decision depends on several factors, ranging from cash flow and balance sheet considerations to the availability, terms, and cost of each option.

### Letters of Credit

A letter of credit is the most popular collateral instrument. It is a form of security issued by a bank with which the insurance buyer has a relationship. With this letter, the bank secures the collateral risk for the insurer. The insurer will require the letter of credit to be "clean and unconditional," so there are no restrictions if the insurer needs to draw on it.

The advantage of letters of credit is their ability to secure collateral without a cash outlay. The disadvantage is the cost of a letter of credit, typically between 1.5 and 3% of the total collateral secured. The cost and availability depends on the bank's perception of the insurance buyer's credit risk, as well as their credit philosophy, which may be impacted by overall economic conditions.

Before the credit crisis and recession that began in 2007-08, corporate balance sheets were generally sound, with plenty of available capital and credit lines. It was relatively easy and inexpensive to get a letter of credit from a bank. As the credit crisis grew, however, the pool of available credit shrunk. At the same time, many businesses had their credit lines tightened and there was a renewed focus on preserving capital.

As a result, more organizations turned to cash as their collateral. Today, however, with improvements in the economy, letters of credit are regaining popularity. Another outcome of the credit crisis was a weakening in the financial condition of many banks. Insurers take a bank's financial health into account before accepting letters of credit from them.

## Cash – Static and Pre-funded

Insurance buyers that have sufficient cash on their balance sheet can decide to provide cash as collateral. In this case, the insurance carrier holds these funds as security for the claims obligations.

If the insurance buyer has the available cash, the advantages of using it as collateral are its simplicity and low administrative costs. Before deciding to accept cash as collateral, insurers will carefully consider the insurance buyer's financial condition. If an organization declares bankruptcy, cash collateral may become unavailable to the insurer.

An additional option when using cash as collateral is pre-funding claims payments. Rather than a typical "static" account where the insurance buyer reimburses carriers monthly for claims paid, the buyer can "pre-fund" the full policy-year expected losses. Interest anticipated on the pre-funded amount is used to offset a portion of the premium cost.

Pre-funding cash provides the buyer with easy cash flow planning. If the insured has a better-than-expected year in losses, then they would receive a partial refund at the first scheduled adjustment date. Alternatively, adverse loss experience would require additional funds to be deposited. Given the current low-interest rate environment and its impact on investments, pre-funding has become a more popular option for companies with available cash.

## Custodial Accounts

Collateral also can be secured by a custodial account such as a trust fund or bank account. When a custodial account is set up, the insurance buyer, insurer, and the bank enter into an agreement, and the account is funded by cash, securities, or other assets, all of which are then held as collateral.

Insurance buyers considering custodial accounts must consider the administrative costs involved with setting up and maintaining these accounts. Costs are similar to those with any type of custodial account. The insurer, on the other hand, considers the quality of the assets securing the account.

## Conclusion

The impact of collateral is an important part of a company's decision to choose a large deductible or other loss-sensitive insurance product, and plays a key role in how well a company is able to maximize the value from a loss-sensitive workers' compensation program.

Since the foundation of a collateral requirement is claims experience, organizations need to be vigilant about containing claims costs. It is important for a company to commit to fully leveraging their insurer's loss control, claims, medical, and pharmacy management expertise. By containing these costs, organizations can lower their "total cost of risk."

In the second of this PMA Executive Brief series, we will explore how capitalizing on Risk Control can help control loss costs.

## About the Author

[Joseph L. Garzone](#) is Assistant Vice President, PMA Companies, Finance. He is responsible for establishing PMA's Corporate Credit Policy, marketing our credit philosophies to client and broker executive management, and developing strategies and products to facilitate the growth of PMA's loss-sensitive business.

Mr. Garzone is an expert in structuring collateral arrangements for large accounts utilizing loss-sensitive insurance products. He works closely with PMA Risk Management Solutions in developing innovative solutions to address client needs. He has spoken at various conferences on collateral issues, including the Annual RIMS Conference, and is a published author on the topic. He has over 20 years of financial and credit experience.

A graduate of the University of Pennsylvania, Mr. Garzone has an MBA from Drexel University and is a Chartered Financial Analyst. He was also a faculty member of The Insurance Society of Philadelphia, teaching CPCU courses in Accounting and Finance, Economics, and Management.

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## About PMA Companies

PMA Companies ([www.pmacompanies.com](http://www.pmacompanies.com)) provides risk management solutions and services in the U.S., specializing in workers' compensation and offering property and casualty insurance. A member of Old Republic Companies, PMA Companies is headquartered in Blue Bell, PA.

Old Republic International Corporation (NYSE: ORI) is one of the nation's 50 largest publicly held insurance organizations.

PMA Companies includes:

- **PMA Insurance Group**, specializing in workers' compensation, and providing other commercial property & casualty insurance products
- **PMA Management Corp. and PMA Management Corp. of New England**, providing results-driven TPA and Risk Services specializing in workers' compensation and liability